Understanding Arbitrage

2004 California Debt and Investment Advisory Commission
October 28, 2004

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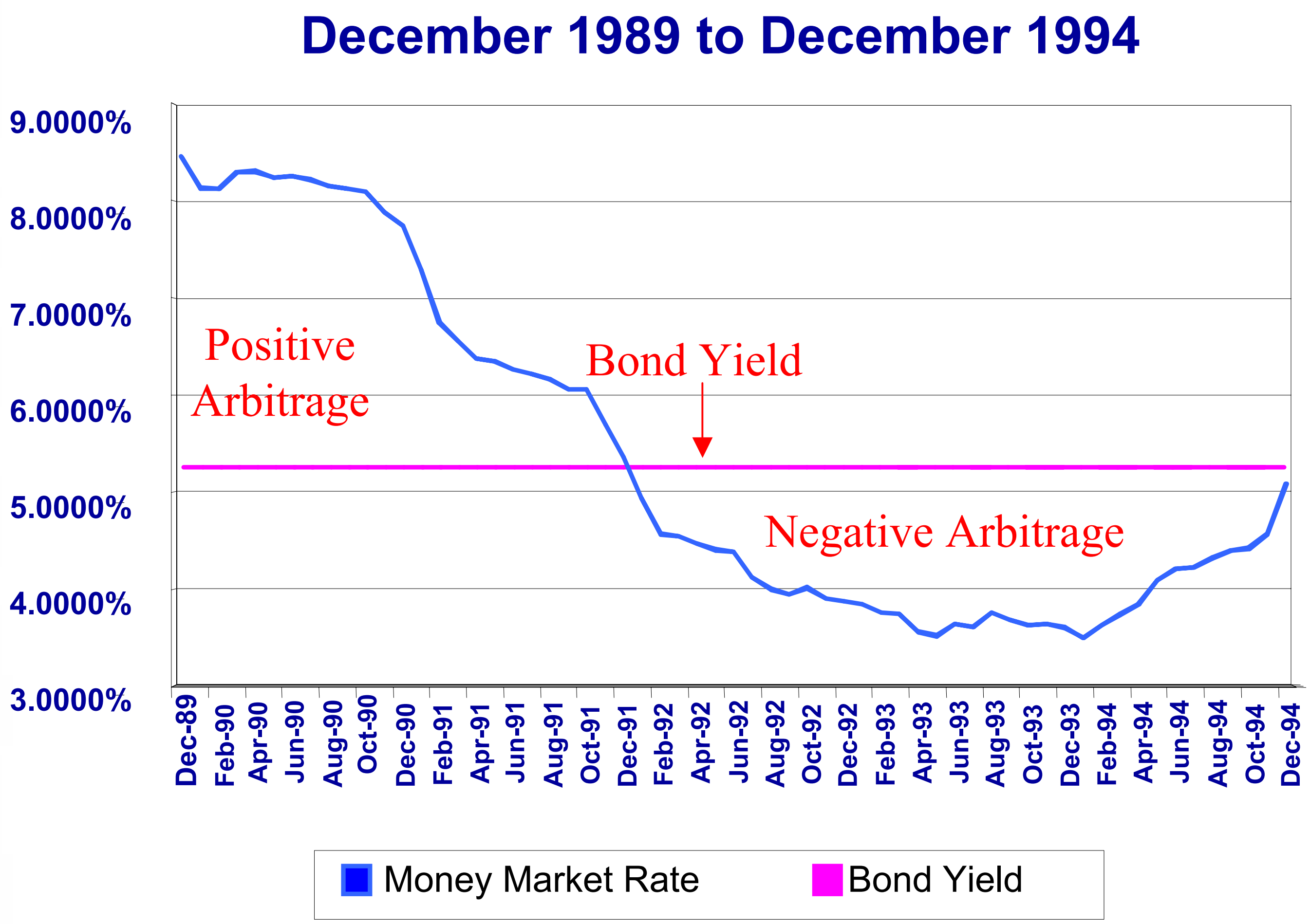
Basics of Arbitrage Compliance for Tax-Exempt Bond Proceeds

Definition of Arbitrage for Tax-Exempt Bonds

Investing tax-exempt proceeds in taxable securities, resulting in a profit or loss.

What is Arbitrage?



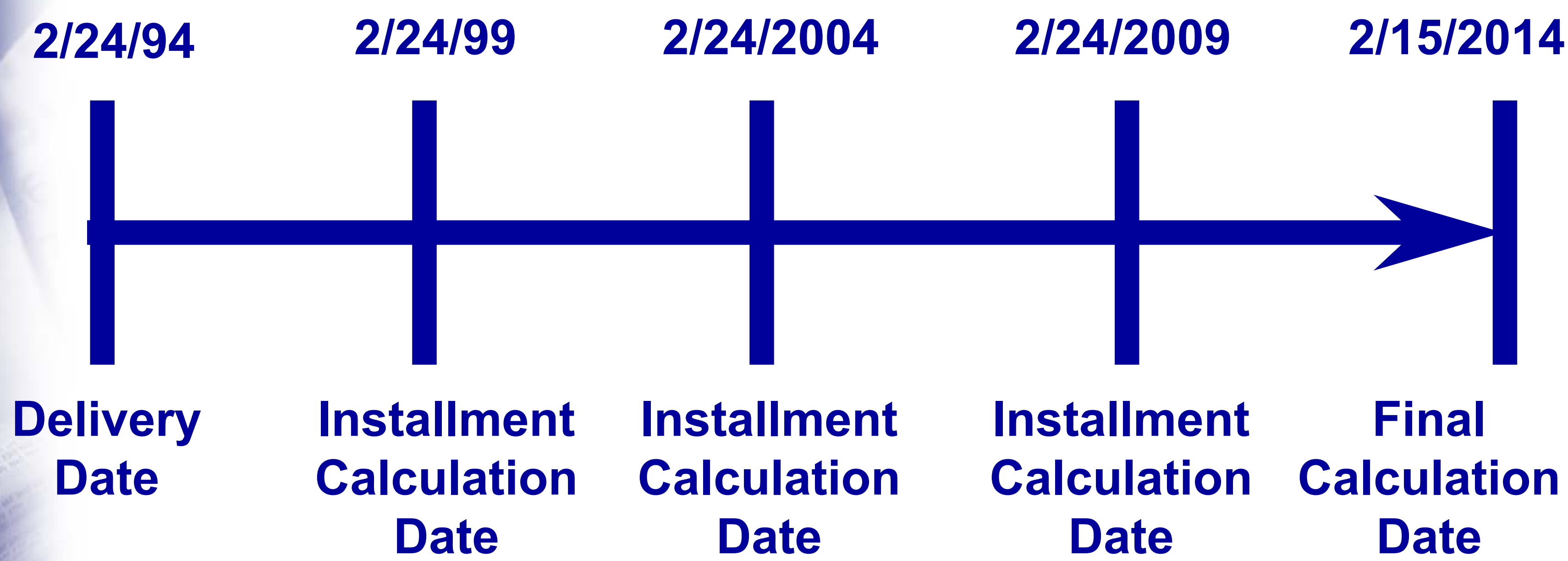
Installment Calculation Dates

- Installments paid at least every 5th bond year.
- Bond year is date selected by the Issuer.
- If no date is selected, bond year ends on each anniversary date of the issue.
- Installment payable within 60 days.

Final Computation Date

- Date all bonds of an issue have been retired (matured or redeemed early).
- Cash defeasance or refunding may accelerate.
- Payment due within 60 days.

Required IRS Reporting Dates



Required Payment Amounts

- Installment Date: 90% of cumulative rebate.
- Final Computations: 100% of unpaid rebate amount.

Payments to the IRS

- Make check payable to Internal Revenue Service.
- Complete Form 8038-T.
- Mail Rebate Payments to IRS Center in Ogden, UT.
- Mail Yield Reduction Payments to IRS Center in Ogden, UT.

IRS Form 8038-T

- Form 8038-T only filed when rebate amount is positive, under current law.
- When to File: "File Form 8038-T when paying the arbitrage rebate to the United States."

Penalties for Noncompliance of Arbitrage Regulations

- Loss of tax-exemption on the issue; or
- Assessment of penalties and interest.

Failure to Pay Rebate

- Bonds will be declared taxable unless:
  - failure was not due to willful neglect; and
  - issuer pays a penalty to the United States.

Penalty Assessment Rates

- Penalty equal to:
  - 50 percent for governmental bonds; or
  - 100 percent for private activity bonds, excluding qualified 501(c)(3) bonds.

Interest also payable on correction amount.

Waiver of the Penalty

- Automatically waived if rebate amount, plus interest, paid within 180 days of the failure's discovery.
- Waiver not allowed if IRS determines the failure was due to willful neglect or issuer is under examination by the IRS.

Recovery of Overpayments

1992 Regulations: Only permitted for mathematical errors.

1993 Regulations: Permitted whenever an overpayment can be demonstrated.

1994 Corrections: Clarified recovery available under prior regulations.

Limitations on Recovery

- Use Form 8038R for filing.
- An overpayment of less than $5,000 may not be recovered before the final computation date.
- Overpayment can only be recovered to the extent that recovery does not result in additional rebate as of the date requested.

Exceptions to the Rebate Requirements

Exceptions to the Rebate Requirements

- Small Issuer Exception
- Investments in Non-AMT Tax-Exempt Obligations
- Debt Service Fund Exclusion
- 6-Month Exception
- 18-Month Exception
- 24-Month Exception

Small Issuer Exception

- Governmental entity with general taxing powers (no private activity bonds).
- Issued $5 million or less in tax-exempt debt during a calendar year.
- Subordinate entity debt included.

Increase in Small Issuer Exception for Schools

- Effective for bonds issued after December 31, 1997, increased to $10 million.
- Effective for bonds issued after December 31, 2001, increased to $15 million.
- No more than $5 million for non-construction.

Illustration of Small Issuer Exception for Schools

	Case 1	Case 2	Case 3
	Exempt	**Exempt**	**Not Exempt**
Non-Construction	$ 5,000,000	$ 4,000,000	$ 6,000,000
Construction	5,000,000	6,000,000	3,000,000
Total Issue Amount	**$ 10,000,000**	**$ 10,000,000**	**$ 9,000,000**

Subordinate Entities

- Subordinate if directly or indirectly controlled by another entity.
- Direct control includes power to approve or remove controlling portion of governing body, or
- Power over use of funds or assets of the controlled entity.
- Not controlled if subordinate entity possesses taxing and police powers.

Tax-Exempt Investment Exception

- Earnings on investments in certain tax-exempt obligations are exempt from rebate.
- Earnings on investments subject to AMT are included in the rebate calculation.
- Low yields and cashflow constraints make this unattractive.

Bona Fide Debt Service Fund Exclusion

- Definition: A fund used primarily to achieve a proper matching of revenue and debt service within each bond year.
- Depleted at least once a year except for a reasonable carryover amount.

Reasonable Carryover Amount

Greater of:

- Earnings on fund for preceding bond year; or
- 1/12th of principal and interest payments for preceding bond year

Bona Fide Debt Service Fund Earnings Limitation

- Fixed rate issues with an average maturity of 5 years or more - DSF is excluded from rebate regardless of amount of interest earned.
- Fixed rate issues with an average maturity of less than 5 years and variable rate issues - include in rebate calculation if more than $100,000 earned in bond year.

Debt Service Fund
Safe Harbor

An issue with an average annual debt service that is not in excess of $2,500,000 may be treated as satisfying the $100,000 limitation.

Monitoring Debt Service Funds

- As interest rates climb, debt service funds for variable rate and short term fixed rate debt could earn more than the $100,000 safe harbor.
- For issues when all bond proceeds have been spent, procedures should be in place to ensure the Debt Service Fund remains bona fide and that no replacement proceeds have been deposited.

Tax and Revenue Anticipation Notes

TRANs

- TRANs are issued to cover working capital needs while waiting to receive revenues from other sources.
- Proceeds may be invested above the bond yield, but earnings will be subject to rebate unless the issue qualifies for a spending exception or small issuer exception.

Special Rules for TRANs

- Temporary period will either be 13 months or two years.
- Issuer must use “proceeds-spent-last” accounting method for working capital.

Small Issuer Exception

- The "Small Issuer Exception" applies in the same manner to TRANs as to other capital project tax-exempt debt in that it exempts an Issuer from rebate.
- TRAN issuers are not exempt from Yield Restriction and therefore must establish either a 13 month or two year temporary period.

"Proceeds-Spent-Last" (PSL)

- An issuer is not allowed to treat bond proceeds as spent until all other *available* working capital has been spent.
- PSL is mandatory for working capital expenditures. Even if bond proceeds are segregated you cannot allocate expenditures until all other *available* sources have been used.

Available vs Unavailable Working Capital

- *Available Amount* is any amount that may be used by the issuer for working capital expenses.
- *Unavailable Amount* is any amount held by the issuer which has been restricted by legislative, judicial, or contractual action as to the use of proceeds.

Working Capital Reserves

- The regulations allow an issuer to set aside a “working capital reserve” and thus treat it as an *unavailable* amount.
- This amount may not exceed 5% of the working capital expenses of the prior fiscal year.

De Minimus Exceptions From PSL

- Numerous De Minimus exceptions exist with relation to PSL.
- The most commonly used exceptions are for costs defined as administrative cost of issuing the bonds, qualified guarantee fees, payment of rebate, and yield reduction payments.

De Minimus Exceptions From PSL

- PSL does not apply to extraordinary, nonrecurring items, such as casualty losses.
- Does not apply to principal and interest on prior issues
- Does not apply to interest unless it is allocable to construction or prior to the production of revenues
- Your rebate provider can provide a complete list.

Cumulative Cash Flow Deficit (CCFD)

- Regulations do not restrict investment of TRAN proceeds provided the face amount of the TRAN does not exceed the cumulative cash flow deficit.
- CCFD calculated for a fiscal year is:

Beginning Balance

+Anticipated Receipts

- <u>Anticipated Expenses</u>

Cumulative Cash Flow Deficit

Safe Harbor for TRANs

- If the CCFD six months after the issue date is at least 90% of the TRAN proceeds, the issue will qualify for the 6-month spending exception.

CCFD

	Balance	Estimated Expenditures	Estimated Receipts	Surplus(/Deficit)
Jun	$ 1,000,000			
July		(750,000)	40,000	290,000
Aug		(900,000)	36,450	(573,550)
Sep		(1,100,000)	32,132	(1,641,418)
Oct		(1,250,000)	26,782	(2,864,636)
Nov		(1,000,000)	20,576	(3,844,060)
Dec		(800,000)	15,779	(4,628,281)
Jan		(1,100,000)	6,000,000	271,719
Feb		(1,289,994)	13,450	(1,004,825)
Mar		(1,000,000)	8,000,000	5,995,175
Apr		(1,535,100)	15,000	4,475,075
May		(2,975,000)	45,000	1,545,075
Jun		(1,515,000)	15,000	45,075

Under this scenario a $6M TRAN issued on June 1 will not meet the 6 month spending exception.

Yield Restriction Rules

Two Separate Rules

Yield Restriction - govern when you may legally earn arbitrage

Arbitrage Rebate - mandate when you must remit arbitrage to IRS

Yield Restriction vs. Arbitrage Rebate

- Prior to 1986 Tax Act, only yield restriction applied.
- After 1986 Tax Act, **both** yield restriction and rebate requirements apply.

Yield Restriction Rules

- In general, gross proceeds may not be invested at a yield materially higher than the yield on the bonds
- Temporary periods

Historical Treatment of Arbitrage

Years	0	Unrestricted "Green Money"	3	Restricted "Red Money"

Prior to 9/1/86	Retain Arbitrage	Do not earn arbitrage
9/1/86 - 6/30/93	Remit Arbitrage	Do not earn arbitrage
7/1/93 and After	Remit Arbitrage	Yield Reduction Payment

Rebate vs. Yield Restriction

Year

1997

1998

1999

2000

2001

Arbitrage Rebate - Blend All 5-Years

Yield Restriction - Only Blend After 3rd Year

Three-Year Capital Projects

Temporary Period

Reasonable Expectations:

- Expenditure Test - 85% in 3 years
- Time Test - Contract for 5% in 6 months
- Due Diligence Test

Other Temporary Periods

◆ Long-term Capital Projects	5 Years
◆ Pooled Financing (loan programs)	6 Months
◆ Debt Service Funds	13 Months
◆ Interest Earnings	1 Year

Other Temporary Periods

- Reserve or Replacement Funds.

- Minor Portion equal to lesser of:
  - 5 percent of sale proceeds; or
  - $100,000

After the Temporary Period

- Yield restrict remaining proceeds; or
- Yield reduction payment *may* be permitted under 1993 Regulations

Yield Reduction Payments

- 1993 administrative solution to yield restriction.
- Yield Reduction Payments (YRPs) are payments made to the IRS on yield restricted funds.
- Paid at same time and manner as a rebate payment.

Yield Reduction Payments

- YRPs allowed for the following situations:
  - Investments qualified for an original temporary period;
  - Investments restricted to a variable yield issue;
  - Transferred proceeds associated with a refunding; or
  - Reserve fund balance in excess of reasonably required limit, but only up to 15% par.
- YRPs not normally allowed for advance re - funding escrows.

YRP Sample #1

		Arbitrage Earned
Years 1-3	(Unrestricted)	10,000
Years 4 & 5	(Restricted)	5,000
Arbitrage Rebate	Payment	15,000
Yield Reduction	Payment	- 0 -

YRP Sample #2

		Arbitrage Earned
Years 1-3	(Unrestricted)	<9,000>
Years 4 & 5	(Restricted)	7,000
Arbitrage Rebate	Payment	-0-
Yield Reduction	Payment	7,000

YRP Sample #3

Arbitrage Earned		
Years 1-3	(Unrestricted)	8,000
Years 4 & 5	(Restricted)	<2,000>
Arbitrage Rebate	Payment	6,000
Yield Reduction	Payment	-0-

YRP Sample #4

Issuer “D” has $15 million GO Bonds and believes that only 75% will be spent within 3 years.

D does NOT qualify for 3 year temporary period, must yield restrict from day one and may not make a yield reduction payment.

Watch Out for Yield Restriction!

If positive arbitrage earned after temporary periods and issue does NOT qualify for yield reduction payment, issue may be considered “arbitrage bonds” and declared taxable by the IRS.

Curing Yield Restriction

- Yield reduction payment, if available
- 0% SLGS to blend down yield
- Cash does not blend down yield

Early Termination of Investment Contracts

Changing Strategies

- The arbitrage rebate regulations apply for the life of the bond.
- All earnings on investments, expected or unexpected, are subject to rebate.
- It’s wise to consider performing a forward-looking rebate calculation before making a significant change in investments.

Provider Initiated Termination

- Premiums ***received*** by the purchaser for the early termination of an investment agreement ***will*** increase total investment earnings.

Purchaser initiated termination

- Premiums ***paid*** by the purchaser for early termination of an investment agreement ***will*** decrease total investment earnings.

Buyer/Seller Beware

- All profit earned on an investment is subject to rebate.
- Before making a significant change to an investment it’s wise to update your rebate calculation.

Abusive Transactions

Definition of Abusive

- Abusive arbitrage is defined as:
  - An action that enables the issuer to exploit the difference between tax-exempt and taxable interest rates, and
  - Overburdening the tax-exempt market.

Exploitation

- An issuer cannot use low-yielding investments late in the life of the bond to offset the abuse of the regulations early in the life of the issue.

Overburdening

- Issuing bonds too early or allowing them to stay outstanding longer than necessary is considered *overburdening* the market.

Recent Abuses in the News

- Improper yield blending.
- Hidden fees in credit enhancements.
- Bonds issued for the purpose of earning arbitrage.

Improper Yield Blending

- Using uninvested cash to blend down an investment yield.
- Offsetting negative earnings during an unrestricted period with positive earnings during a restricted period.
- Netting the positive liability earned on one bond issue with the negative liability of another bond issue.

Hidden Fees in Credit Enhancements

- Credit enhancement payments that shift credit risk are allowed to increase the yield on a bond.
- These payments must meet several criteria to be considered qualified guarantees including, fees for services other than transfer of risk must be listed separately and excluded from the calculation.

Bonds issued for the purpose of earning arbitrage

- IRS recently settled with “Telephone Book” type pool bond issuers that failed to give adequate public notice about the projects to be financed.
- The bond pools had hundreds of potential projects and the IRS felt there was very little intention of ever loaning out the proceeds.
- The financing team has been sanctioned and the proceeds remaining in the pool have been used to redeem the outstanding bonds.

“Most Blatant Abuse”

- The winner of the “Most Blatant Abuse” award goes to the financing team that convinced a school board that as long as they “intended” to undertake the project they were not actually required to spend the bond proceeds. The financing was sold as a way to earn $225,000 of arbitrage and keep the profits.

Who gets the Blame

- Although the IRS and SEC are working hard to punish the “snake oil salesmen” who promote these products, issuers are still held accountable.
- Settlements are being reached, but the right to make the bonds taxable will always be a consideration.

How to Protect Yourself

- Ask questions. If it sounds too good to be true, it probably is.
- Consult an objective party who can clarify the impact of the transaction as it relates to the IRS regulations.
- Learn the basics of arbitrage.

IRS Enforcement Program

IRS Enforcement Program

- Tax-exempt bond enforcement program started in June 1993 in response to GAO criticisms.
- IRS coordinates its efforts with SEC.
- Organization structure revamped effective October 1, 1999.

IRS Enforcement Structure

- Tax-Exempt & Government Entities Operating Division serves three sectors:
  – Employee Plans
  – Exempt Organizations
  – Government Entities

Government Entities Sector

- Government Entities Section monitors compliance for:
  - Tax-exempt bonds
  - Federal, State and Local governments
  - Indian Tribal governments
- Approximately 270 employees are being assigned to the Government Entities Sector

Government Entities Sector

- Two functions:
  - Outreach, planning and review
  - Field operations and review

Outreach, Planning & Review (OPR)

- Voluntary Compliance Program
  - Settled about 20 cases in 2001
- IRS Website
  - www.irs.gov/bonds
- Publish CPE Texts
- Forms
  - 8038-R

Field Operations

- Currently about 300 exams/claims pending
- Processed about 290 cases/claims in 2001
- Correspondence Examination
- Yield Burning Examination

IRS Enforcement Program

- Random audits
- Issues identified by third parties
- Issues with possible abuses (GICs, Escrows, etc.)
- Issuer refund requests

Results of 2000 Compliance Survey

- 89 surveys mailed to private activity issuers
- Issued between 1992 and 1993
- Selected based upon 8038s filed at issuance
- 5 issuers failed to do any rebate calculations
- 22 issuers did calculations improperly

2001 Correspondence Examination

- 95 surveys mailed to fixed rate bonds issued in 1995
- Randomly selected issuers in 32 states
- Average size of issues - $50 million
- Surveys mailed in December 2001
- See sample survey letter - Tab 7 of your binder

Results of 2001 Correspondence Examination

- 57 – complied with rebate requirements
- 25 – IRS had questions/concerns
- 13 – have not yet responded
- May lead to full-fledged field audits

Areas of Interest in 2002

- Tax Revenue Anticipation Notes
- Solid Waste Issues
- Housing - Single Family and Multi Family
- 3rd Correspondence Examination - Private Activity Bonds Sold in 1995
- Document Retention Program w/ GFOA

Status of IRS Enforcement

As of December 2001:

- 44 agents and 9 field managers
- 350 issues currently being audited
- 95 random correspondence examinations in progress

Voluntary Closing Agreement Program (VCAP)

Allows issuers to approach the IRS to settle tax law problems with their bonds

- Announced October 1, 2001
- Results in smaller amount paid than if audited
- Issuers permitted to initiate discussions anonymously
- IRS is requesting comments about the program from the public

Voluntary Closing Agreement Program (VCAP)

VCAP not available when:

- Issue currently under examination
- Violation can be remedied by existing remedial actions
- Tax-exempt status of bonds is at issue in court
- IRS determines that violation was due to willful neglect

IRS Enforcement Program

- 3-Year statute of limitations on ability for IRS to tax most bondholders.
- Record retention of certain information required for up to 6 years after bond issue has been retired.

Managing Your Rebate Program

Managing Your Rebate Program

- Establish good policies and procedures for managing your bond issues.
- Negotiate the provisions of the Tax Certificate.
- Stay organized.
- Maintain a rebate reporting schedule that allows time for decisions at critical junctures.

Policies and Procedures

- Analyze activity on your bonds for all purposes, not just rebate.
- Maintain consistent procedures.
- Consult with Council before making critical decisions relating to your tax-exempt debt.

Negotiate the Provisions of your Tax Certificate.

- Do not allow the drafter to routinely include boiler plate language in your Tax Certificate.
- Be sure you agree with any and all special elections.
- Read the Tax Certificate.

Stay Organized

- Track bond proceed expenditures in detail.
- Avoid commingling funds whenever possible.
- Retain all records for the life of the bond, plus 3 years.

Recommended Reporting Schedule

- Annual reporting on all variable rate issues and fixed rate bonds that have accrued liabilities.
- Initial calculation at the end of the first bond year to monitor special elections and optimize investment strategies.
- Review after year 3 when the construction fund must be yield restricted.
- Minimum reporting schedule - every 5 years.

Sample Tracking System

Agency
Arbitrage Rebate Compliance Summary
as of 1/31/04

Issue Date	Original Principal	Issue Name	Last Report	Liability	Next Report
10/07/1993	$2,405,000.00	Peacock Gap Refunding	10/01/1998	($26,061.00)	10/01/2003
01/28/1997	$5,250,000.00	1997 Revenue Bonds	05/31/2003	($42,382.16)	01/28/2007
06/30/1999	$23,504,004.00	1999 TAB	06/30/2003	$215,345.89	06/30/2004
12/06/2001	$3,220,000.00	2001 Revenue, Series A	-	-	12/06/2006
10/20/2002	$25,020,000.00	TARB Series 2002	-	-	10/20/2007
04/17/2003	$7,605,000.00	2003 Lease Revenue Bonds	-	-	04/17/2008